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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CEA-01 CIAE-00 COME-00 EB-08
EA-07 FRB-03 INR-07 IO-13 NEA-10 NSAE-00 USIA-06
OPIC-03 SP-02 TRSE-00 LAB-04 SIL-01 AGRE-00 OMB-01
NSC-05 SS-15 STR-04 L-03 H-01 /112 W
-----022035 117920 /53

R 021954Z MAR 77
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PASS: CEA, TREAS, FRB

E.O. 11652: N/A
TAGS: OECD, ECON

SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC) REVIEW OF DENMARK

REF: (A) EDR(77)5; (B) COPENHAGEN 1072

1. SUMMARY: AT FEBRUARY 23 EDRC REVIEW OF DENMARK, SECRETARIAT STRESSED THAT COEXISTENCE OF HIGH INFLATION AND UNEMPLOYMENT AND LARGE CURRENT ACCOUNT DEFICIT REFLECTED "WIDENING IMBALANCES AND WORSENING TRADEOFFS" WHICH HAD DEVELOPED IN DANISH ECONOMY OVER TIME. DANISH DEL (LED BY LOSHE, MINISTRY OF ECONOMIC AFFAIRS) AGREED WITH THRUST OF SECRETARIAT PROPOSITION, BUT NOTED THAT EXISTING IMBALANCES SHOULD BE SEEN AGAINST BACKGROUND OF RECENT RECESSION (AND OIL PRICE INCREASE), SAID THAT CORRECTIVE MEASURES WERE BEING ADOPTED, AND REQUESTED THAT SECRETARIAT SOFTEN ITS PRESENTATION SOMEWHAT. SECRETARIAT AND EDRC AGREED TO SOFTENING, BUT STRESSED THAT LIMITED OFFICIAL USE

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PUBLISHED SURVEY SHOULD UNEQUIVOCALLY URGE DANES TO:
(A) PERSIST IN EFFORT TO ELIMINATE CURRENT ACCOUNT DEFICI BY IMPROVING COMPETITIVE POSITION USING BOTH DEMAND MANAGEMENT AND INCOME POLICIES (NEITHER DANES NOR SECRETARIA FELT THAT GREATER EXCHANGE RATE FLEXIBILITY WOULD BE HELPFUL IN FACILITATING ADJUSTMENT PROCESS); AND (B) ABANDON "STOP-GO" POLICY PATTERN OF PAST IN FAVOR OF STABLE, MORE

PREDICTABLE POLICIES. DANES AND SECRETARIAT AGREED THAT OUTLOOK FOR 1977 WAS FOR MODERATE GNP GROWTH, HIGH BUT DECELERATING INFLATION RATE, AND MODERATE DECLINE IN CURRENT ACCOUNT DEFICIT. DANES DID NOT EXPECT TO ENCOUNTER EXTERNAL FINANCING PROBLEMS IN 1977, BUT LIKE SECRETARIAT FELT THAT PRESENT RATE OF DEBT ACCUMULATION IS UNSUSTAINABLE. END SUMMARY

2. SHORT-TERM PROSPECTS; DOMESTIC OUTLOOK: DIFFERENCE BETWEEN SECRETARIAT AND DANISH FORECASTS OF REAL GNP GROWTH IN 1977 WAS MINIMAL. WHILE SECRETARIAT PROJECTS GROWTH RATE OF 1.5 PERCENT COMPARED WITH DANISH FORECAST OF 2-1/2 PERCENT, DIVERGENT ESTIMATE OF GROWTH OF RESIDENTIAL CONSTRUCTION (SECRETARIAT SEES 15 PERCENT DECLINE; DANES, ZERO GROWTH) ACCOUNTS FOR MOST OF DIFFERENCE; SECRETARIAT AND DANES NOTED THAT ACTIVITY IN CONSTRUCTION SECTOR FLUCTUATED WIDELY AND THAT MARGIN OF FORECASTING ERROR IS HUGE.

3. WAGES AND PRICES: DANES AND SECRETARIAT FORECAST SHARP ACCELERATION IN TOTAL WAGE COSTS IN EARLY 1977 BECAUSE OF (A) POSITIVE CARRYOVER FROM 1976; (B) ELIMINATION OF SUBSIDY WHICH COMPENSATED FIRMS FOR PAST INDEXATION-RELATED WAGE INCREASES; (C) WAGE INCREASE UNDER INDEXATION PROVISIONS OF INCOMES POLICY (SO-CALLED FIRST "PORTION") AND (D) ADDITIONAL WAGE INCREASE INTENDED TO GUARANTEE 2 PERCENT INCREASE IN REAL WAGES. HOWEVER, BOTH DANES AND SECRETARIAT FORECAST STRONG DECELERATION IN GROWTH OF WAGES IN SECOND HALF OF YEAR LIMITED OFFICIAL USE

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1977 WITH ANNUAL RATE OF INCREASE (INCLUDING WAGE DRIFT OF 2 PERCENT) FALLING TO ABOUT 8 PERCENT BY YEAR END. (SECRETARIAT PUTS YEAR-OVER-YEAR GROWTH OF WAGES AT ABOUT 12.5 PERCENT, WHEREAS DANES ESTIMATE THIS FIGURE AT ROUGHLY 10 PERCENT WITH DIFFERENCE LYING IN USE OF DIFFERENT WAGE COST INDICES. SINCE DANES AND SECRETARIAT FAILED TO REACH AGREEMENT IN WHICH INDEX MORE APPROPRIATE PUBLISHED SURVEY WILL NOT INCLUDE YEAR-OVER-YEAR PROJECTIONS.) LIKE SECRETARIAT, DANES EXPECTED PROFILE OF INFLATION DURING YEAR TO FOLLOW THAT OF WAGES AND FORECAST 8.5 PERCENT AVERAGE INCREASE IN CONSUMER PRICES (COMPARED WITH EARLIER OFFICIAL FORECAST OF 8 PERCENT AND WITH SECRETARIAT PROJECTION OF 9 PERCENT). THUS SINCE EXPECTED MOVEMENT OF MONEY WAGES AND PRICES IMPLIES DECELERATION OF REAL WAGE INCREASE DURING 1977 AND BECAUS PRODUCTIVITY GROWTH IS FORECAST TO AVERAGE 5 PERCENT,

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OPIC-03 SP-02 TRSE-00 LAB-04 SIL-01 AGRE-00 OMB-01
NSC-05 SS-15 STR-04 L-03 H-01 /112 W
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INCREASE IN UNIT LABOR COSTS SHOULD TAPER OFF SUBSTANTIALLY DURING 1977.

4. DANES EMPHASIZED THAT INCOMES POLICY HAMMERED OUT IN "AUGUST COMPROMISE" (AUGUST, 1976) WOULD PLAY KEY ROLE IN OVERALL STABILIZATION EFFORT AND AGREED WITH EDRC CHAIRMAN'S COMMENT THAT BROAD POLITICAL SUPPORT FOR AUSTERITY MEASURES SEEMED TO GIVE GOD "GREEN LIGHT" TO PERSIST IN ITS EFFORT TO REDRESS ECONOMIC SITUATION. HOWEVER, IN RESPONSE TO COMMENT BY UK DEL, DANES ACKNOWLEDGED THAT USE OF INCOMES POLICY TO RESTRAIN WAGE INCREASES COULD NOT CONTINUE INDEFINITELY. THEY EXPRESSED HOPE THAT PRESENT INCOMES POLICY WOULD ENDURE THROUGH 1979 BUT THAT SUBSEQUENTLY, ANOTHER "GADGET" WOULD HAVE TO BE FOUND TO ACCOMPLISH THE SAME RESULT.

5. DANES AGREED WITH SECRETARIAT VIEW THAT PROJECTED SLOW GNP GROWTH IN 1977 WOULD IMPLY NO INCREASE IN EMPLOYMENT, AND HENCE AN INCREASE IN UNEMPLOYMENT RATE FROM PRESENT HISTORICALLY HIGH LEVEL OF 5 PERCENT. THEY POINTED

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OUT, HOWEVER, THAT SELECTIVE EMPLOYMENT CREATION MEASURES WERE DESIGNED TO ABSORB EXPECTED INCREASE IN LABOR FORCE IN 1977 SO THAT WHILE TOTAL EMPLOYMENT MAY NOT RISE, NEITHER WOULD UNEMPLOYMENT RATE. DANES NOTED GOD'S SURPRISE THAT HIGH UNEMPLOYMENT RATE HAD NOT PRODUCED MAJOR POLITICAL OUTCRY AND ATTRIBUTED APPARENT POLITICAL ACCEPTABILITY OF HIGH UNEMPLOYMENT TO BROAD AND GENEROUS UNEMPLOYMENT INSURANCE COVERAGE AND TO FACT THAT PERIOD OF UNEMPLOYMENT FOR MOST INDIVIDUALS HAS BEEN GENERALLY OF SHORT DURATION.

6. CURRENT ACCOUNT: DUE TO LARGER THAN ANTICIPATED STOCK ACCUMULATION AT END OF 1976, MUCH OF WHICH SPILLED OVER INTO IMPORTS, GOD NOW ESTIMATES THAT CURRENT ACCOUNT REGISTERED 11.7 BILLION KRONER DEFICIT LAST YEAR, RATHER THAN 10.8 - 11 BILLION KRONER ESTIMATED PREVIOUSLY. BY SAME TOKEN, INFLUENCE OF STOCK MOVEMENTS ON IMPORTS SHOULD, ACCORDING TO DANES, BE LESS IN 1977. THUS, GOD HAS REVISED ITS CURRENT ACCOUNT FORECAST FOR 1977 DOWNWARD TO 7.7 BILLION KRONER FROM EARLIER 8.5 BILLION KRONER PROJECTION. DANES INDICATED THAT PROJECTED SMALLER 1977 CURRENT ACCOUNT DEFICIT, TOGETHER WITH REPAYMENT ON EXTERNAL DEBT, COULD GENERATE EXTERNAL FINANCING REQUIREMENT OF 10-11 BILLION KRONER. THEY DID NOT EXPECT TO ENCOUNTER ANY EXTERNAL FINANCING DIFFICULTIES IN 1977, NOTED THAT OFFICIAL BORROWING (MOST OF WHICH HAS ALREADY BEEN CONTRACTED) WOULD COVER BULK (7-8 BILLION KRONER) OF REQUIREMENTS AND THAT TIGHT MONETARY POLICY WOULD HELP INSURE SUFFICIENT PRIVATE CAPITAL INFLOW TO COVER THE BALANCE.

7. DESPITE MAINTAINING SANGUINE ASSESSMENT OF EXTERNAL FINANCING SITUATION IN 1977, DANES SUPPORTED SECRETARIAT CONTENTION THAT PRESENT RATE OF EXTERNAL DEBT ACCUMULATION WAS UNSUSTAINABLE AND THAT NEED TO REDRESS CURRENT ACCOUNT POSITION WAS PARAMOUNT. IN THIS CONNECTION, LIMITED OFFICIAL USE

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THEY FELT THAT SECRETARIAT EMPHASIS ON DETERIORATION OF DANISH COMPETITIVE POSITION WAS SOMEWHAT OVERDONE. THEY ACKNOWLEDGED THAT DANISH EXPORTERS HAD LOST MARKET SHARES IN 1976, BUT PUT MOST OF BLAME FOR THIS DEVELOPMENT ON UNFAVORABLE GEOGRAPHIC (IMPORTANT MARKETS INCLUDE, ACCORDING TO DANES, UK AND ITALY) AND PRODUCT COMPOSITION OF DANISH EXPORTS. CONSISTENT WITH THIS VIEW, GOD PROJECTS GROWTH OF EXPORT VOLUMES EQUAL TO THAT OF MARKETS IN 1977. MOREOVER, DANES STRESSED THAT DECELERATION OF RATE OF UNIT LABOR COST INCREASE DURING 1977 COULD PERMIT GAIN IN MARKET SHARES IN 1978. SECRETARIAT WAS NOT CONVINCED AND CHOSE TO VIEW EVOLUTION OF DANISH COMPETI-

TIVE POSITION FROM IMPORT SIDE, NOTING UPWARD TREND IN ELASTICITY OF IMPORTS WITH RESPECT TO GROWTH OF DOMESTIC DEMAND. SECRETARIAT EMPHASIZED THAT INCREASING FOREIGN PENETRATION OF DOMESTIC MARKET HAD PUT SEVERE SQUEEZE ON EXPOSED SECTORS LEADING TO (A) DEMISE OF SOME LABOR-INTENSIVE SECTORS; (B) SHIFT TOWARD CAPITAL INTENSITY IN OTHERS, AND (C) SQUEEZE ON PROFITS AND CONSEQUENT DECLINE IN INVESTMENT WITH ADVERSE LONG-RUN EFFECTS ON DANISH PRODUCTIVITY.

8. SEVERAL DELS SUGGESTED INDIRECTLY (U.S.) OR DIRECTLY (AUSTRALIA) THAT MORE ACTIVE USE OF EXCHANGE RATE CHANGES COULD ASSIST EFFORT TO RESTORE CURRENT ACCOUNT EQUILIBRIUM

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OPIC-03 SP-02 TRSE-00 LAB-04 SIL-01 AGRE-00 OMB-01
NSC-05 SS-15 STR-04 L-03 H-01 /112 W
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R 021954Z MAR 77
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DANES REJECTED ALTERNATIVE, ARGUING AS FOLLOWS: (A) AS CASES OF ITALY AND UK HAVE SHOWN, ADOPTION OF MORE FLEXIBLE EXCHANGE RATES HAVE DESTABILIZING EFFECTS WHEN IMBALANCES ALREADY EXIST IN THE ECONOMY; (B) DEPRECIATION OF KRONER WOULD HAVE INFLATIONARY CONSEQUENCES WITH WINDFALL PROFITS ACCRUING RANDOMLY TO CERTAIN GROUPS; AND (C) PERVERSE ("J CURVE") EFFECTS WOULD RESULT IN SHORT-RUN INCREASE IN CURRENT ACCOUNT DEFICIT. DANES SAID THAT THEY INTENDED TO HOLD KRONER WITHIN SNAKE AND TO RELY ON INCOMES POLICY TO MAINTAIN CONSISTENCY BETWEEN VALUE OF

KRONER AND EVOLUTION OF DOMESTIC COSTS. SECRETARIAT WAS SOMEWHAT SCHIZOPHRENIC ON THIS ISSUE AT FIRST SUPPORTING MORE FLEXIBLE EXCHANGE RATE POLICY, BUT FINALLY COMING DOWN HARD AGAINST IT. (SECRETARIAT FEELING WAS THAT PUBLISHED RECOMMENDATIONS ALONG THIS LINE COULD BE SELF-FULFILLING, AND WILL NOT DISCUSS EXCHANGE RATE POLICY ALTERNATIVES IN PUBLISHED SURVEY.)

9. FISCAL AND MONETARY POLICY: DANES EMPHASIZED THAT BURGEONING CURRENT ACCOUNT DEFICIT IN 1976 WAS IMPORTANTLY LIMITED OFFICIAL USE

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ATTRIBUTABLE TO TEMPORARY STIMULATORY MEASURES IMPLEMENTED IN 1975 AND WAS MAIN REASON FOR SHIFT TOWARD RESTRICTIVE FISCAL POLICY LAST YEAR. THEY ESTIMATE TOTAL RESTRICTIVE EFFECT OF AUGUST PROGRAM (ELIMINATION OF TEMPORARY STIMULATORY MEASURES, ADOPTION OF NEW ONES) AT ABOUT 6 PERCENT OF 1976 GNP. NEVERTHELESS, LARGE BUDGET DEFICIT COMPLICATED TASK OF MONETARY POLICY IN 1976. DANES NOTED THAT GOALS OF MONETARY POLICY LAST YEAR WERE TO INSURE NON-INFLATIONARY FINANCING OF BUDGET DEFICIT, SUPPORT VALUE OF KRONER AND TO PREVENT RISE IN LONG-TERM INTEREST RATES SO AS NOT TO IMPEDE RECOVERY IN CONSTRUCTION SECTOR. (DANES NOTED THAT GOD HAD SECURED AUTHORITY TO ISSUE 10 BILLION KRONER IN BONDS TO COVER BUDGET DEFICIT, BUT THAT AUTHORITY WAS NOT USED BECAUSE OF IMPLICIT POLITICAL AGREEMENT THAT PUBLIC SECTOR FINANCIAL OPERATIONS SHOULD NOT PUT UPWARD PRESSURE AS LONG-TERM INTEREST RATES.) U.S. NOTED (PER REF C) THAT GOD MONETARY AUTHORITIES APPEARED TO HAVE TOO FEW TOOLS RELATIVE TO POLICY OBJECTIVES, AND SUGGESTED THAT SIMILAR SITUATION COULD MATERIALIZE IN 1977. DANES AGREED THAT THIS WAS THE CASE IN 1976, BUT SAID THAT RESUMPTION OF CAPITAL INFLOWS, WHICH BEGAN IN FOURTH QUARTER OF 1977, WOULD ALLOW INCREASED BOND SALES AND SUCCESSFUL PURSUIT OF "OPERATION TWIST" (SEE REF C, PARA 9) IN 1977. SECRETARIAT NOTED THAT IF TWIST IN YIELD CURVE DID NOT COME ABOUT GOD WOULD FACE DIFFICULT TRADE-OFF BETWEEN (A) RELATIVELY HIGH INTEREST RATES DICTATED BY EXTERNAL CONSIDERATIONS AND IMPLIED BY OBJECTIVE OF NON-INFLATIONARY FINANCING OF PUBLIC DEBT AND (B) LOWER LONG-TERM RATES DESIGNED TO FOSTER RESIDENTIAL CONSTRUCTION. TO EDRC'S DISBELIEF, DANES RESPONDED THAT CONFLICT WOULD NOT ARISE BECAUSE RESTRAINT IN GROWTH OF CONSTRUCTION SECTOR WAS APPROPRIATE. (DANES LATER EXPLAINED THAT SHRINKAGE OF CONSTRUCTION SECTOR WAS MEDIUM-TERM OBJECTIVE WHILE SUPPORT OF SAME WAS IMPORTANT ELEMENT OF SHORT-RUN COUNTERCYCLICAL POLICY.) EDRC GAVE UP. LIMITED OFFICIAL USE

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10. MAIN EDRC CONCLUSION WAS THAT DANES SHOULD ABANDON "STOP-GO" POLICIES OF PAST IN FAVOR OF STEADY, MORE PREDICTABLE POLICIES. SPECIFICALLY, COMMITTEE EMPHASIZED THAT GOD SHOULD RESIST TEMPTATION FOR EXCESSIVE STIMULUS OF DOMESTIC DEMAND IN EVENT THAT PRESENT RESTRICTIVE POLICY SHOULD INDUCE IMPROVEMENT OF CURRENT ACCOUNT SITUATION.

11. POINTS RAISED PARA 7, REF B COVERED PARAS 5, 3-4, AND 6-8.
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Message Attributes

Automatic Decaptioning: X
Capture Date: 01-Jan-1994 12:00:00 am
Channel Indicators: n/a
Current Classification: UNCLASSIFIED
Concepts: ECONOMIC CONDITIONS, REPORTS, STUDIES
Control Number: n/a
Copy: SINGLE
Sent Date: 02-Mar-1977 12:00:00 am
Decaption Date: 01-Jan-1960 12:00:00 am
Decaption Note:
Disposition Action: RELEASED
Disposition Approved on Date:
Disposition Case Number: n/a
Disposition Comment: 25 YEAR REVIEW
Disposition Date: 22 May 2009
Disposition Event:
Disposition History: n/a
Disposition Reason:
Disposition Remarks:
Document Number: 1977OECDP06225
Document Source: CORE
Document Unique ID: 00
Drafter: n/a
Enclosure: n/a
Executive Order: N/A
Errors: N/A
Expiration:
Film Number: D770072-0283
Format: TEL
From: OECD PARIS
Handling Restrictions: n/a
Image Path:
ISecure: 1
Legacy Key: link1977/newtext/t197703101/aaaadlfq.tel
Line Count: 348
Litigation Code IDs:
Litigation Codes:
Litigation History:
Locator: TEXT ON-LINE, ON MICROFILM
Message ID: 244188ac-c288-dd11-92da-001cc4696bcc
Office: ACTION EUR
Original Classification: LIMITED OFFICIAL USE
Original Handling Restrictions: n/a
Original Previous Classification: n/a
Original Previous Handling Restrictions: n/a
Page Count: 7
Previous Channel Indicators: n/a
Previous Classification: LIMITED OFFICIAL USE
Previous Handling Restrictions: n/a
Reference: 77 COPENHAGEN 1072
Retention: 0
Review Action: RELEASED, APPROVED
Review Content Flags:
Review Date: 01-Mar-2005 12:00:00 am
Review Event:
Review Exemptions: n/a
Review Media Identifier:
Review Release Date: n/a
Review Release Event: n/a
Review Transfer Date:
Review Withdrawn Fields: n/a
SAS ID: 2940027
Secure: OPEN
Status: NATIVE
Subject: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE (EDRC) REVIEW OF DENMARK
TAGS: ECON, DA, OECD
To: STATE
Type: TE
vdkgvwkey: odb://SAS/SAS.dbo.SAS_Docs/244188ac-c288-dd11-92da-001cc4696bcc
Review Markings:
Margaret P. Grafeld
Declassified/Released
US Department of State
EO Systematic Review
22 May 2009
Markings: Margaret P. Grafeld Declassified/Released US Department of State EO Systematic Review 22 May 2009